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SUPERIOR COURT FOR THE STATE OF CALIFORNIA

IN AND FOR THE COUNTY OF LOS ANGELES

CITY OF LONG BEACH,

Plaintiff,

vs.

RICHARD S. FULD, JR.,
CHRISTOPHER M. O'MEARA,
ERIN M. CALLAN,
MICHAEL L. AINSLIE,
JOHN F. AKERS,
ROGER S. BERLIND,
THOMAS H. CRUIKSHANK,
MARSHA JOHNSON EVANS,
SIR CHRISTOPHER GENT,
ROLAND A. HERNANDEZ,
HENRY KAUFMAN,
JOHN D. MACOMBER,
ERNST & YOUNG LLP,
and DOES 1 through 20, inclusive,

Defendants.

CASE NO.

COMPLAINT FOR DAMAGES

- 1) Violation of California Corporations Code § 25400, *et seq.*;
- 2) Fraud and Deceit; and
- 3) Negligent Misrepresentation

JURY TRIAL DEMANDED

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1 Plaintiff City of Long Beach ("Long Beach" or "Plaintiff"), by its undersigned attorneys,
2 makes the following allegations on information and belief based upon the investigation of counsel,
3 except as to the allegations pertaining specifically to Plaintiff and Plaintiff's counsel which are
4 based on personal knowledge. The investigation conducted by Plaintiff's counsel included, but
5 was not limited to, a review and analysis of: (i) public filings, including Lehman Brothers Holdings
6 Inc.'s ("Lehman" or the "Company") filings and prospectuses with the United States Securities and
7 Exchange Commission ("SEC"); (ii) securities analysts' reports and advisories about the Company;
8 (iii) press releases issued by Defendants and others; (iv) public statements made by Defendants
9 including the Congressional testimony of Richard S. Fuld, Jr.; and (v) publicly available news
10 articles and reports.

11 I. NATURE OF ACTION

12 1. Plaintiff Long Beach is a public entity that invested monies through its investment
13 pool (the "Pool") organized and managed pursuant to the California Government Code. Through
14 the Pool, Plaintiff purchased 27-day short-term commercial paper issued by Lehman (the "Lehman
15 Securities" or "Securities") on September 3, 2008 in order to meet its liquidity needs on
16 September 30, 2008. The amount invested by Plaintiff in the Lehman Securities was \$19,963,250.
17 The Pool invests monies received from tax revenues, bond proceeds, and user fees for its public
18 facilities. As a public municipality, Long Beach invests monies in a conservative and safe manner.
19 All investments are made pursuant to its Investment Policy Statement, which sets standards above
20 those established by the California Government Code. In 2000, Long Beach became the first
21 municipal public investment pool to retain Standard & Poor's Rating Services ("S&P") to rate its
22 investment portfolio. S&P's most recent review in September of 2008 rated the Pool at AAf/S1,
23 S&P's highest rating. Despite the fact that Defendants were aware of materially adverse facts
24 about Lehman's financial condition on September 3, 2008, a mere two weeks before the Company
25 filed for bankruptcy, said Defendants did not disclose the financial disaster that was about to
26 decimate the Company. Instead, Defendants lulled the Plaintiff, and the rest of the market, into a
27 false sense of security that Lehman would survive, right up to the brink of the bankruptcy filing.
28

1 2. Plaintiff's claims are brought against certain officers and directors of Lehman for
2 false and misleading statements made in connection with the purchase of the Lehman Securities
3 that violated provisions of the California Corporations Code and state common law. Plaintiff also
4 brings claims against Lehman's public auditor, Ernst & Young LLP ("Ernst"), for materially false
5 and misleading audit opinions issued by it on Lehman's consolidated financial statements for the
6 fiscal years 2005, 2006, and 2007.

7 3. Plaintiff alleges that in connection with the offering and sale of the Lehman
8 Securities on September 3, 2008, Lehman, through its officers and directors, made material
9 misstatements and omissions. The representations were materially false and misleading because at
10 the time Plaintiff purchased the Lehman Securities and for several years prior to that date, Lehman
11 was experiencing a number of materially adverse events that were not revealed or sufficiently
12 disclosed to investors such as Plaintiff. Those events include, but are not limited to: (i) the failure
13 to disclose Lehman's continued and aggressive marketing of high risk securities secured with
14 subprime mortgages that had suffered material increases in default rates due to declining home
15 values; (ii) the failure to set aside adequate reserves to cover Lehman's ever increasing portfolio of
16 underperforming subprime mortgage-backed securities and commercial mortgage-backed
17 securities; (iii) the continued marketing of high risk mortgage bonds and Collateralized Debt
18 Obligations ("CDOs") secured by assets that were declining sharply in market value even as the
19 market for such securities collapsed; (iv) the promotion of unsustainable business practices
20 designed to exploit the mortgage lending business despite the material, and mostly undisclosed,
21 risks involved; (v) the insufficient capital levels of Lehman; (vi) the failure to timely and
22 adequately write-down commercial and residential mortgage and real estate assets; and (vii) the
23 failure to prevent and remedy such improper and harmful actions that resulted in Lehman filing for
24 bankruptcy on September 15, 2008 under Chapter 11 of the United States Bankruptcy Code.¹ As a
25 result of Lehman's and the Defendants' efforts to keep adverse financial information from the

26
27 ¹ No bankrupt party is being sued herein, nor does Plaintiff seek any relief in the United States
28 Bankruptcy Court through this action. The outcome of Plaintiff's claims herein will not alter the
debtor's rights, liabilities, options, or freedom of actions. Therefore, this action will have no effect
on the estate being administered in bankruptcy.

1 investing public, including Plaintiff, Lehman was able to raise money through its debt issuances
2 right up to the point when bankruptcy became inevitable. Given the lack of adequate disclosures in
3 Lehman's financial statements, the efforts to put a favorable public spin on Lehman's financial
4 woes, and the push to deflect concern about the viability of investments in Lehman, and the
5 resulting high investment ratings given to Lehman by the various national rating agencies, Plaintiff
6 was not aware, and could not have become aware, of Lehman's serious financial problems when it
7 purchased the Lehman Securities.

8 4. Defendants knew, or should have known, of the material misstatements and
9 omissions of material facts made to investors, including Plaintiff, prior to Plaintiff's purchase of
10 the Securities directly from Lehman. Plaintiff purchased the Lehman Securities less than two
11 weeks prior to Lehman's bankruptcy filing. At that time, Defendants knew or should have known
12 about Lehman's dire financial position and imminent collapse.

13 5. A slight glimpse into the adverse facts affecting Lehman's business was first revealed
14 on March 18, 2008 in a Company issued press release announcing decreasing net revenues and
15 declining asset values due to "continued deterioration in the broader credit markets, in particular
16 residential mortgages, commercial mortgages and acquisition finance." However, the disclosure
17 was incomplete and materially misleading as to the full extent of Lehman's financial problems.
18 Moreover, over the next several months, Lehman's officers directly denied the seriousness of such
19 problems. Defendant Fuld told shareholders in April 2008 that "the worst is behind us" and on
20 June 16, 2008 told investors that "[Lehman's] capital and liquidity positions have never been
21 stronger."

22 6. Within a few weeks after March 18, 2008, Lehman returned to the capital markets,
23 raising \$4 billion by issuing preferred stock. These and similar efforts failed, and on
24 September 15, 2008, Lehman filed a voluntary petition to reorganize under Chapter 11 in the
25 United States Bankruptcy Court for the Southern District of New York. This is the largest
26 bankruptcy filing in history. As a result, Plaintiff wrote down to zero value its investment of
27 \$19,963,250 in the Lehman Securities.
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7. Plaintiff and the City of Long Beach taxpayers have suffered significant financial damage as a result of Defendants' material misstatements and omissions, and brings this action to recover damages incurred thereby as well as the costs and expenses of this litigation and further relief as may be just and proper.

II. JURISDICTION AND VENUE

8. The claims asserted herein arise under, and are pursuant to, the California Corporations Code, as well as under California common law.

9. This Court has jurisdiction over the subject matter of this action pursuant to its statutory and other powers to afford damages and other relief on the matters stated herein. This Court also has personal jurisdiction over Defendants because the acts and omissions of Defendants, including the solicitation and sale of the Lehman Securities, took place and resulted in damages and other adverse effects upon Plaintiff within the State of California. The amount in controversy exceeds the jurisdictional minimum of this Court.

10. At all relevant times, each Defendant named herein maintained contacts with and conducted business in California. Lehman, at all times prior to September 15, 2008, maintained offices and conducted substantial business operations in California. Through their employees and agents, Lehman sold the Lehman Securities to public entities in California, including Plaintiff.

11. Venue is proper in the Los Angeles Superior Court pursuant to California Code of Civil Procedure section 395, because the acts and omissions complained of herein, including the solicitation and sale of the Lehman Securities through the use of materially false and misleading information by Lehman officers and employees, took place and caused damages to, and had other adverse effects upon, Plaintiff within the territorial jurisdiction of this Court.

III. PARTIES

12. Defendant Richard S. Fuld, Jr. (“Fuld”) has been Chairman of the Board of Directors of Lehman Brothers Holdings Inc. and Lehman Brothers Inc. (“LBI”) since 1994, and Chief Executive Officer (“CEO”) of the Company since 1993. He was Chairman of Lehman’s Executive Committee. He was President and Chief Operating Officer of Lehman Brothers Holdings Inc. and LBI from 1993 to 1994, President and Co-CEO of the Lehman Brothers Division of Shearson

1 Lehman Brothers Inc. from 1990 to 1993, Vice Chairman of Shearson Lehman Brothers from 1984
2 until 1990, and has been a Director of LBI since 1984. He joined Lehman Brothers in 1969, soon
3 after graduating from the University of Colorado. Defendant Fuld received an MBA from New
4 York University in 1973. Fuld, as CEO of Lehman since 1993, controlled and directed the
5 operations of Lehman and was instrumental in the selection and election of its outside directors
6 from 1993 to September 15, 2008. Defendant Fuld signed all SEC informational filings made by
7 Lehman prior to September 15, 2008.

8 13. Defendant Christopher M. O'Meara ("O'Meara") was the head of Lehman's
9 Worldwide Risk Management. From 2004 until December 1, 2007, he was Lehman's Chief
10 Financial Officer ("CFO") and Controller. O'Meara joined the Company in 1994 as Lehman's
11 Global Controller. Prior to joining Lehman, Defendant O'Meara served as Managing Director and
12 Controller of several business units at Bankers Trust Company. Prior to that, he served as a senior
13 manager of Ernst & Young's Financial Services practice. O'Meara graduated from Georgetown
14 University with a degree in business administration and is a Certified Public Accountant.
15 Defendant O'Meara signed Lehman's Form 10-Ks for the fiscal years ended 2005 and 2006.

16 14. Defendant Erin M. Callan ("Callan") was CFO and Global Controller of Lehman
17 from December 2007 until she resigned from that position in June 2008. She was also a member of
18 Lehman's Executive Committee. Callan joined Lehman in 1995, and she led its Global Finance
19 Solutions Group and Global Finance Analytics Group prior to becoming CFO. Before joining
20 Lehman, Callan practiced corporate tax law, with a focus on financial instruments and new
21 products. Defendant Callan graduated magna cum laude from Harvard University, and is a
22 graduate of New York University School of Law. Defendant Callan signed Lehman's Form 10-K
23 for the fiscal year ended 2007.

24 15. Defendants Fuld, O'Meara, and Callan are referred to collectively as the "Officer
25 Defendants." During 2005, 2006, 2007, and continuing into 2008, each of the Officer Defendants
26 received substantial compensation. Defendant Fuld received cash or cash equivalent compensation
27 of \$14,500,000 in 2005, \$19,523,679 in 2006, and \$5,000,000 in 2007. In addition, he received
28 restricted stock grants of \$14,942,021 in 2005, \$10,903,060 in 2006, and \$35,000,000 in 2007.

1 Defendant O'Meara had cash compensation of \$2,700,000 in 2005, \$2,500,000 in 2006, and
2 \$2,850,000 in 2007. In addition, he received restricted stock grants of \$2,571,285 in 2005,
3 \$3,571,495 in 2006, and \$6,642,857 in 2007.

4 16. Defendant Michael L. Ainslie ("Ainslie") has been a Director of Lehman Brothers
5 Holdings Inc. since 1996, and served as a member of Lehman's Audit Committee. He is currently
6 a Director of Lehman Brothers Bank, FSB. Defendant Ainslie was the President, CEO, and a
7 Director of Sotheby's Holdings from 1984 to 1994. Ainslie received a B.A. in Economics from
8 Vanderbilt University, and an MBA from Harvard Business School. Defendant Ainslie signed
9 Lehman's Form 10-Ks for the fiscal years ended 2005, 2006, and 2007.

10 17. Defendant John F. Akers ("Akers") has been a Director of Lehman Brothers
11 Holdings Inc. since 1996. He served as the Chairman of Lehman's Compensation and Benefits
12 Committee and as a member of the Finance and Risk Committee. Defendant Akers was the CEO
13 of IBM from 1986 until 1993. He received a B.S. from Yale University. Defendant Akers signed
14 Lehman's Form 10-Ks for the fiscal years ended 2005, 2006, and 2007.

15 18. Defendant Roger S. Berlind ("Berlind") has been a Director of Lehman Brothers
16 Holdings Inc. since 1985. He served as a member of Lehman's Audit Committee and the Finance
17 and Risk Committee. Defendant Berlind received an A.B. from Princeton University. Berlind was
18 one of the founders of the brokerage firm Carter, Berlind, Potoma & Weill, a company that would
19 later, through many mergers and acquisitions, become Lehman Brothers Holdings Inc. In 1975,
20 Berlind retired from active business responsibilities, and began a theatrical producing career.
21 Defendant Berlind signed Lehman's Form 10-Ks for the fiscal years ended 2005, 2006, and 2007.

22 19. Defendant Thomas H. Cruikshank ("Cruikshank") has been a Director of Lehman
23 Brothers Holdings Inc. since 1996 and served as the Chairman of Lehman's Audit Committee and
24 as a member of the Nominating and Corporate Governance Committee. He is currently a Director
25 of LBI. Defendant Cruikshank was the Chairman and CEO of Halliburton Company from 1989 to
26 1995, President and CEO of Halliburton Company from 1983 to 1989, and served as a Director of
27 Halliburton from 1977 to 1996. He joined Halliburton Company in 1969, and served in several
28

1 senior accounting and finance positions before being named CEO. Defendant Cruikshank signed
2 Lehman's Form 10-Ks for the fiscal years ended 2005, 2006, and 2007.

3 20. Defendant Marsha Johnson Evans ("Evans") has been a Director of Lehman Brothers
4 Holdings Inc. since 2004. She served as the Chair of Lehman's Nominating and Corporate
5 Governance Committee, and as a member of the Compensation and Benefits Committee and the
6 Finance and Risk Committee. Defendant Evans received her B.A. in Law & Diplomacy from
7 Occidental College, and her M.A. in International Security from Fletcher School of Law and
8 Diplomacy at Tufts University. Defendant Evans signed Lehman's Form 10-Ks for the fiscal years
9 ended 2005, 2006, and 2007.

10 21. Defendant Sir Christopher Gent ("Gent") has been a Director of Lehman Brothers
11 Holdings Inc. since 2003. He served as a member of Lehman's Audit Committee and the
12 Compensation and Benefits Committee. Defendant Gent is the former CEO of Vodafone, a British
13 mobile phone company. He is now Chairman of GlaxoSmithKline, a British pharmaceutical
14 company. Defendant Gent signed Lehman's Form 10-Ks for the fiscal years ended 2005, 2006,
15 and 2007.

16 22. Defendant Roland A. Hernandez ("Hernandez") has been a Director of Lehman
17 Brothers Holdings Inc. since 2005. He served as a member of Lehman's Finance and Risk
18 Committee. Defendant Hernandez was the CEO of Telemundo Group from 1995 to 2000. He
19 received his A.B. from Harvard University, where he graduated cum laude, and his J.D. from
20 Harvard Law School. Defendant Hernandez signed Lehman's Form 10-Ks for the fiscal years
21 ended 2005, 2006, and 2007.

22 23. Defendant Henry Kaufman ("Kaufman") has been a Director of Lehman Brothers
23 Holdings Inc. since 1995. He served as the Chairman of Lehman's Finance and Risk Committee.
24 Defendant Kaufman is President of Henry Kaufman & Company Inc. From 1962 to 1988,
25 Kaufman worked at Salomon Brothers Inc. where he was Managing Director and a member of the
26 Executive Committee. He was also a Vice Chairman of Salomon Inc. Before joining Salomon
27 Brothers, Kaufman was an economist at the Federal Reserve Bank of New York. Defendant
28 Kaufman received a B.A. in Economics from New York University, an M.S. in Finance from

1 Columbia University, and a Ph.D. from the New York University's Stern School of Business and is
2 a leading financial analyst. Defendant Kaufman signed Lehman's Form 10-Ks for the fiscal years
3 ended 2005, 2006, and 2007.

4 24. Defendant John D. Macomber ("Macomber") has been a Director of Lehman
5 Brothers Holdings Inc. since 1994. He served as a member of Lehman's Compensation and
6 Benefits Committee, the Executive Committee, and the Nominating and Corporate Governance
7 Committee. Defendant Macomber is a graduate of Yale University and Harvard Business School.
8 Defendant Macomber signed Lehman's Form 10-Ks for the fiscal years ended 2005, 2006, and
9 2007.

10 25. Defendants Fuld, Ainslie, Akers, Berlind, Cruikshank, Evans, Gent, Hernandez,
11 Kaufman, and Macomber are collectively referred to herein as the "Director Defendants."
12 Defendants Fuld, O'Meara, Callan, Ainslie, Akers, Berlind, Cruikshank, Evans, Gent, Hernandez,
13 Kaufman, and Macomber are collectively referred to herein as the "Individual Defendants."

14 26. Each of the Individual Defendants participated in the drafting, preparation, and/or
15 approval of various false and misleading public statements made by each them and others on behalf
16 of Lehman as well as in the informational filings made with the SEC, such as Forms 10-K and 10-
17 Q. Each of the Individual Defendants was responsible for ensuring the truth and accuracy of the
18 representations contained in Lehman's public statements.

19 27. Defendant Ernst is a worldwide public accounting firm with numerous offices and
20 partners located in California. For the fiscal years ended November 30, 2005, 2006, and 2007,
21 Ernst acted as Lehman's public auditors and issued unqualified audit opinions on the consolidated
22 financial statements of Lehman for those fiscal years.

23 28. Plaintiff City of Long Beach purchased the Lehman Securities in reliance upon the
24 false and misleading information issued or approved by each of the Defendants named herein, and
25 was damaged thereby. As alleged herein, each of these Defendants was sophisticated and
26 knowledgeable about the financial markets, as well as Lehman's business, its disclosure
27 obligations, and its financial condition. Each of the Defendants, either individually, or in the case
28 of Ernst, through its partners and staff, had particular expertise based on their education, business

1 experience, and services rendered to other companies concerning the conditions in the financial
2 markets which brought down Lehman.

3 29. Plaintiff is ignorant of the true names and capacities of the other Defendants sued
4 herein as Does 1 through 20, inclusive (the "Doe Defendants"), and therefore sues these Doe
5 Defendants by such fictitious names. Plaintiff will amend this Complaint to allege the Does' true
6 names and capacities when ascertained. Plaintiff is informed and believes, and thereon alleges,
7 that each such fictitiously named Doe Defendant is legally responsible in some manner for the
8 events and conduct referred to herein, and legally caused injury and damages to Plaintiff as herein
9 alleged.

10 30. At all pertinent times, each Defendant was an agent and/or employee of the other
11 Defendants, and each of them, and was acting in the course and scope of such agency and/or
12 employment, and with the consent, permission, and/or authorization of the other Defendants, and
13 each of them. Defendants, and each of them, are individually sued herein as participants and aiders
14 and abettors in the improper acts and transactions alleged herein.

15 31. Each of the Defendants owed to the Plaintiff, as an investor in Lehman Securities, a
16 duty to make a reasonable and diligent investigation of all statements made to the public. This duty
17 included performing an appropriate investigation to ensure that the statements made were true, and
18 that there were no omissions of material facts required to be stated in order to make the statements
19 Defendants made not misleading to the public, investors, and readers of Lehman's financial
20 statements. As herein alleged, each of the Defendants violated these specific duties and
21 obligations.

22 32. Non-party Lehman Brothers Holdings Inc. is a Delaware corporation with its
23 principal executive offices located at 745 Seventh Avenue, New York, New York. Lehman is an
24 investment banking firm which, through its subsidiaries, provides various financial services to
25 corporations, governments and municipalities, institutions, and high-net-worth individuals
26 worldwide. The Company's activities include raising capital for clients through securities
27 underwriting and direct placements, corporate finance, mortgage and real estate related activities,
28 merchant banking, securities sales and trading, research services, and private client services. On

1 September 15, 2008, Lehman filed a voluntary petition to reorganize under Chapter 11 of the
2 United States Bankruptcy Code. For this reason, Lehman has not been named as a Defendant in
3 this Complaint.

4 **IV. FACTUAL ALLEGATIONS**

5 33. Since 1998, over seven million homeowners in the United States have purchased
6 homes using subprime mortgages, loans made to borrowers who do not qualify for conventional
7 mortgages. By the end of 2007, over one million of those homeowners had defaulted on their
8 loans. Unbeknownst at the time, the origins of the current mortgage crisis and Lehman's
9 involvement can be traced back to at least 2001. Using the cheap money available after the Federal
10 Reserve drastically cut interest rates following the attacks of September 11, 2001, Wall Street
11 investment firms found a new money source in the emerging subprime mortgage market. Lehman
12 was the leading participant in this market during 2002-2003 and very nearly owned this new and
13 profitable market. Lehman became involved in all aspects of the subprime mortgage market –
14 acting as underwriters for subprime lenders going public, providing lines of credit for their
15 subprime loans, and buying the mortgages to be converted into asset-backed securities for resale to
16 investors. At all stages of this cycle, Lehman collected substantial amounts of fees and interest
17 payments from its activities.

18 34. By at least 2003, Lehman's involvement in the United States mortgage market, in
19 particular the subprime mortgage market, represented a significant and material portion of its
20 revenues and earnings. Besides its support of numerous subprime lenders, Lehman participated in
21 all aspects of the mortgage market including origination, servicing, and securitization of
22 mortgages. In 2003, Lehman acquired Aurora Loan Services LLC ("Aurora"). Aurora originated
23 and serviced mortgages mainly in what became known as the subprime mortgage market.
24 Lehman's exposure to mortgages, both residential and commercial, including subprime loans,
25 continued to increase by material amounts in 2004, 2005, 2006, and 2007. For example, Lehman
26 originated about \$27 billion of commercial mortgages in 2005. In 2006, commercial loans by
27 Lehman increased to \$34 billion and approximately \$60 billion in 2007. By early 2008, Lehman
28

1 held the largest dollar amount of commercial mortgages compared to any other financial company
2 in the United States.

3 35. In 2005, Lehman described itself as:

4 a market leader in mortgage-backed securities trading. We originate
5 residential and commercial mortgage loans as part of our mortgage
6 trading and securitization activities. We originated approximately
7 \$85 billion and \$65 billion of residential mortgage loans in 2005 and
2004, respectively. We securitized approximately \$133 billion and
\$101 billion of residential mortgage loans in 2005 and 2004,
respectively....

8 Lehman's Form 10-K for fiscal year ended November 30, 2005.

9 36. Lehman's involvement in the subprime market was also providing a substantial and
10 increasing portion of its revenues and reported profits from 2004 through 2007. In 2006, Lehman
11 alone underwrote \$51.8 billion in securities backed by subprime loans. With numerous
12 unscrupulous lenders promising borrowers zero percent down loans with no credit checks, Lehman
13 bankrolled such companies' massive fraud on homeowners while collecting substantial fees at
14 every step in the process. Unbeknownst to the investing public, by September 2007 over 20% of
15 the subprime loans that Lehman had securitized in 2006 were in default.

16 37. As of the first quarter of fiscal year 2005 (quarter ended February 28, 2005), Lehman
17 increasingly relied on the mortgage markets, particularly subprime mortgages, for its revenue and
18 profit growth. Net revenue from Lehman's Capital Markets division, which included its mortgage-
19 backed and asset-backed securities operations, increased over the previous year by 21% to \$2.7
20 billion. Lehman stated that "[t]he record results in Fixed Income Capital Markets reflect a strong
21 performance across all major businesses, and **in particular mortgages and interest rate**
22 **products.**" (Emphasis added.) Its reliance on the mortgage markets continued in the second
23 quarter of 2005 (quarter ended May 31, 2005). "[T]he Fixed Income business reported revenues of
24 \$1.8 billion in the second quarter of fiscal 2005, a 23% increase from \$1.4 billion reported in the
25 prior year.... Mortgages and real estate remained resilient, **driven by high levels of securitization**
26 **and asset monetization activity.**" (Emphasis added.) Defendant Fuld stated in a Company press
27 release dated June 14, 2005 that "[w]ith our continued discipline around expense and risk
28 management, we are well-positioned to continue to deliver strong returns to our shareholders."

1 38. In the second half of fiscal 2005, Lehman's financial results continued to be driven
2 by its mortgage-backed and asset-backed securities business. In the third quarter of fiscal 2005
3 (quarter ended August 31, 2005), Lehman reported fixed income revenues of \$1.9 billion, up 37%
4 from the previous year's third quarter. "These results were attributable to increased contributions
5 from the [Company's] commercial mortgage and real estate business, [and] continued strength in
6 residential mortgages...." On December 13, 2005, Lehman reported financial results for the fourth
7 quarter and the full fiscal year. Lehman's record results included fixed income revenues showing a
8 22% increase in the fourth quarter of 2005 over the fourth quarter of 2004.

9 39. As disclosed in its Form 10-K for the fiscal year ended November 30, 2005, which
10 was filed with the SEC on February 13, 2006 ("2005 10-K"), Lehman's mortgage business
11 represented a significant portion of its operations:

12 *Mortgage Origination, Secured Lending and Mortgage- and Asset-*
13 *Backed Securities.* Lehman Brothers Bank, FSB, offers traditional
14 and online mortgage banking services to individuals as well as
15 institutions and their customers. Lehman Brothers Bankhaus AG, a
16 German bank, offers lending and real estate financing to corporate
17 and institutional borrowers worldwide. We originate commercial
18 and residential mortgage loans through Lehman Brothers Bank,
19 Lehman Brothers Bankhaus and other subsidiaries in the U.S.,
20 Europe and Asia. We are a leading underwriter of and market-maker
21 in residential and commercial mortgage- and asset-backed securities
and are active in all areas of secured lending, structured finance and
securitized products. We underwrite and make markets in the full
range of U.S. agency-backed mortgage products, mortgage-backed
securities, asset-backed securities and whole loan products. We are
also a leader in the global market for residential and commercial
mortgages (including multi-family financing) and leases. In 2005,
we established Lehman Brothers Commercial Bank, a Utah-chartered
industrial loan company, in order to issue certificates of deposit to
institutions and conduct certain lending activities.

22 The 2005 10-K disclosed that fixed income revenue, which mainly represented revenues received
23 from its mortgage operations, had increased by 28% over 2004 to \$7.3 billion. The 2005 10-K
24 stated:

25 Fixed Income net revenues were a record \$7.3 billion in 2005,
26 increasing 28% compared with 2004 driven by double digit revenue
27 increases from each geographic region and record revenues across a
28 number of businesses including commercial mortgage and real estate,
residential mortgage origination and securitization, and interest rate
products. Revenues from our commercial mortgage and real estate
businesses increased substantially in 2005 reaching record levels, as
the strong demand for commercial real estate properties, the recovery

1 in certain property markets and relatively low interest rates drove
2 asset sales and robust levels of securitizations. Revenues from our
3 residential mortgage origination and securitization businesses
4 increased in 2005 from the robust levels in 2004, reflecting record
5 volumes and the continued benefits associated with the vertical
6 integration of our mortgage origination platforms. We originated
7 approximately \$85 billion and \$65 billion of residential mortgage
8 loans in 2005 and 2004, respectively. We securitized approximately
9 \$133 billion and \$101 billion of residential mortgage loans in 2005
10 and 2004, respectively, including both originated loans and those we
11 acquired in the secondary market. While the performance in our
12 mortgage businesses reached record levels, these businesses were
13 affected by somewhat lower levels of mortgage origination volumes
14 and revenues in the U.S. in the latter half of 2005, partly offset by
15 stronger volumes and revenues outside the U.S. We originated
16 approximately \$27 billion and \$13 billion of commercial mortgage
17 loans in 2005 and 2004, respectively, the majority of which has been
18 sold through securitization or syndication activities during both 2005
19 and 2004.... The mortgage securitization business was notably
20 strong, with revenues in mortgage products benefiting from the low
21 rate environment as well as the continued vertical integration of our
22 mortgage origination platforms.

23 The 2005 10-K was signed by Defendants Fuld, O'Meara, Ainslie, Akers, Berlind, Cruikshank,
24 Evans, Gent, Hernandez, Kaufman, and Macomber.

25 40. Throughout 2005, as Lehman reported record financial results, driven in large part by
26 its mortgage-backed and asset-backed securities operations, problems began to emerge with many
27 of the subprime lenders it had relied upon for such revenues. A growing number of these lenders
28 were failing in 2005. Even as early as November 2004, Defendant Fuld recognized **privately** that
low interest rates and cheap credit would create a bubble that could one day pop. "It's paving the
road with cheap tar," Fuld admitted to colleagues. "When the weather changes, the potholes that
were there will be deeper and uglier." One reason, among others, that the statements made by
Defendants and others on behalf of Lehman were materially false and misleading is because they
failed to reveal the potential negative impact of Lehman's significant exposure in the mortgage-
backed securities markets as the largest underwriter of such mortgage-backed securities. Nowhere
in Lehman's public statements and SEC filings did Defendants reveal Lehman's substantial
involvement with predatory subprime lenders, including its underwriting of wholesale lines of
credit to such lenders and Lehman's purchase of their toxic loans for resale to investors through the
securitization process. Lehman's public statements also failed to disclose that as a result of the

1 deteriorating market conditions and rapidly declining asset values, particularly relating to real
2 estate assets, Lehman was in desperate need for capital and at substantial risk of defaulting on the
3 Lehman Securities.

4 41. Lehman's public statements and SEC filings materially misrepresented the risks
5 associated with the purchase of the Lehman Securities. Significantly missing from the disclosures
6 in the "Risk Factors" section of the numerous SEC filings by Lehman made prior to Plaintiff's
7 purchase of the Lehman Securities was any reference to the effect a down market would have on
8 Lehman's financial position or the price of the Securities based upon the Company's business
9 operations. Nor did Lehman disclose that its residential and commercial mortgage and real estate
10 assets were overvalued by **billions of dollars**. Had Defendants conducted a proper and adequate
11 investigation of the true facts, they would have known that the softening mortgage market,
12 weakening credit market, and declining real estate values would have a material impact on the
13 price of the Lehman Securities.

14 42. During fiscal year 2006, Lehman's exposure to the commercial and residential
15 mortgage markets expanded further. In its Form 10-K for the fiscal year ended November 30,
16 2006, which was filed with the SEC on February 13, 2007 ("2006 10-K"), Lehman disclosed that
17 fixed income revenue had increased to \$8.4 billion, an increase of 15% over fiscal year 2005. A
18 material portion of fixed income revenues came from Lehman's operations in commercial and
19 residential mortgage origination and securitization of mortgage loans. The 2006 10-K was signed
20 by Defendants Fuld, O'Meara, Ainslie, Akers, Berlind, Cruikshank, Evans, Gent, Hernandez,
21 Kaufman, and Macomber.

22 43. Nowhere in either the 2005 10-K or 2006 10-K did Lehman reveal the extreme risks
23 it had taken upon itself or its material exposure to a decline in the residential and commercial real
24 estate markets. In fact, on March 14, 2007, when Lehman announced its "record net revenues" for
25 the first quarter of fiscal year 2007, Defendant O'Meara, Lehman's CFO at the time, stated in a
26 conference call with analysts that as a result of Lehman's real estate exposure, it was "well
27 positioned to benefit from this evolving situation given our experience in this sector as well as our
28 ample liquidity and risk management practices." O'Meara represented that Lehman had no

1 material exposure to rising delinquencies in the subprime mortgage market stating, "this is
2 reasonably well contained at this point."

3 44. Throughout the rest of 2007 and up until September 15, 2008, Lehman, through SEC
4 filings and the public statements of its officers, continued to deny that Lehman faced any material
5 risk from the plummeting United States real estate markets. While other financial firms took multi-
6 billion dollar write-downs on their mortgage-backed securities, Lehman denied any significant
7 problems with its mortgage related business. On July 18, 2007, Lehman spokeswoman Kerrie
8 Cohen responded to questions about the Company's exposure to subprime mortgage loan defaults
9 by stating: "The rumors regarding subprime exposure are totally unfounded." Despite having the
10 largest mortgage related holdings of any Wall Street firm, Lehman disclosed on September 18,
11 2007 a write-down of only \$700 million of assets, with no disclosure whatsoever as to what portion
12 of that amount came from mortgage-backed assets. In comparison, Citibank disclosed a credit loss
13 of \$5.9 **billion** on mortgage related securities, UBS a write-down of approximately \$3.7 **billion** and
14 Merrill Lynch an astounding \$7.9 **billion** (more than 11 times Lehman's write-down), all around
15 the same time. In statements to analysts and investment professionals during the fall of 2007,
16 Lehman officers continued to assert that it would not be necessary to write off any significant
17 portion of Lehman's mortgage-backed securities portfolio. In fact, following the collapse of two
18 Bear Stearns hedge funds in the summer of 2007, Lehman increased its exposure to the subprime
19 market by purchasing additional mortgage-backed securities in early 2008.

20 45. On January 29, 2008, Lehman filed its Form 10-K for the fiscal year ended
21 November 30, 2007 ("2007 10-K"). While acknowledging some of the problems it faced from
22 what it described as a "slowdown" in the United States housing market, Lehman again failed to
23 disclose in its 2007 10-K the real and severe problems with its mortgage and real estate operations.
24 Instead, Lehman reported:

25 On the basis of a record first half and a reasonably successful
26 navigation of difficult market conditions in the second half, we
27 achieved our fourth consecutive year of record net revenues, net
28 income and diluted earnings per common share in 2007. Net income
totaled \$4.2 billion, \$4.0 billion and \$3.3 billion in 2007, 2006 and
2005, respectively, increasing 5% in 2007 and 23% in 2006 from the
corresponding 2006 and 2005 periods, respectively. Diluted earnings

1 per common share were \$7.26, \$6.81 and \$5.43 in 2007, 2006 and
2 2005, respectively, up 7% in 2007 and 25% in 2006 from the
corresponding prior periods, respectively.

3 The 2007 10-K was signed by Defendants Fuld, Callan, Ainslie, Akers, Berlind, Cruikshank,
4 Evans, Gent, Hernandez, Kaufman, and Macomber.

5 46. At the time Lehman sold the Lehman Securities to Plaintiff, Lehman's officers and
6 directors were aware of materially adverse facts concerning the Company's mortgage-backed asset
7 portfolio and the mortgage markets in general. Despite such knowledge, Lehman's officers and
8 directors failed to take the necessary steps to lower Lehman's exposure or to disclose the risks to
9 the purchasers of Lehman Securities, including Plaintiff. The market volatility was adversely and
10 materially harming Lehman's business, which was driven by an aggressive pursuit of the
11 mortgage-backed underwriting business, and such market volatility would inevitably adversely
12 affect the Company's business in the future. Each of the public statements alleged above, and the
13 concealment of materially adverse facts about Lehman's financial condition, were done with the
14 knowledge and approval of the Individual Defendants, and Lehman operated in this manner under
15 their direction and authority.

16 47. Even though Lehman was aware of and experiencing material problems with its
17 mortgage-backed assets during 2008, the Individual Defendants continued to downplay the extent
18 and severity of these problems. On March 18, 2008, Lehman released financial results for the
19 quarter ended February 29, 2008. The Company's press release stated the following about
20 Lehman's Capital Markets division:

21 [R]eported net revenues of \$1.7 billion in the first quarter of fiscal
22 2008, a decrease of 52% from \$3.5 billion in the first quarter of fiscal
23 2007. Fixed Income Capital Markets reported net revenues of \$262
24 million, a decrease of 88% from \$2.2 billion in the first quarter of
fiscal 2007 ... [resulting from] continued deterioration in the broader
credit markets, **in particular residential mortgages, commercial
mortgages and acquisition finance.**

25 (Emphasis added.)

26 48. Despite the sharp downturn in revenues for the quarter, Lehman's officers continued
27 to deny that Lehman faced any serious financial problems. Defendant Callan stated in a conference
28 call on March 18, 2008, "I think it's fair to say we continue to do a very, very good job managing

1 the risk of residential mortgages, an area that I think we're credited with a lot of expertise, a great
2 franchise." Lehman's common stock rose by over 45% on that date. While the Company's
3 prospects temporarily appeared to improve after March 2008, Lehman's continued exposure in the
4 mortgage-backed asset markets, particularly in subprime mortgage-backed securities, remained
5 substantial. Despite such exposure, Lehman officers continued their upbeat assessments. At
6 Lehman's annual shareholders meeting in April 2008, Defendant Fuld stated that "the worst is
7 behind us."

8 49. On June 3, 2008, *Bloomberg News* published an article titled "Lehman Loses up to
9 \$700 million on Hedging Positions, FT Says." The article noted that the Company lost between
10 \$500 and \$700 million in the second quarter of 2008 which "may prompt the bank to seek more
11 capital by selling a stake to an outside investor." On June 9, 2008, the Company issued a press
12 release announcing that it had priced a \$4 billion public offering of 143 million shares of common
13 stock at \$28 per share.

14 50. The very same day, and a full week ahead of schedule, the Company issued a press
15 release announcing its financial results for the second quarter ended May 31, 2008. The Company
16 reported a net loss of \$2.8 billion. The press release went on to state:

17 **Capital Markets is expected to report net revenues of negative**
18 **(\$2.4) billion in the second quarter of fiscal 2008**, compared to
19 **\$1.7 billion in the first quarter of fiscal 2008 and \$3.6 billion in the**
20 **second quarter of fiscal 2007. Fixed Income Capital Markets is**
21 **expected to report net revenues of negative (\$3.0) billion,**
22 **compared to \$0.3 billion in the first quarter of 2008 and \$1.9 billion**
23 **in the second quarter of 2007.**

24 (Emphasis added.)

25 51. The almost \$3 billion loss represented the Company's first-ever loss since becoming
26 a public company in 1994. Lehman also said that it would attempt to raise an additional \$6 billion
27 in new capital through the issuance of stock.

28 52. On Monday, June 16, 2008, Lehman released its actual results for the second quarter
of 2008, which matched the \$2.8 billion or \$5.14 per share numbers announced a week prior. As it
turns out, most of the loss was due to about \$3.7 billion in write-downs for bad loans. Yet, on that

1 same date, Defendant Fuld again downplayed the serious financial problems at Lehman telling
2 Lehman investors that “[o]ur capital and liquidity positions have never been stronger.”

3 53. On August 22, 2008, Korea Development Bank (“KDB”) expressed an interest in
4 buying Lehman. The news sent Lehman’s stock up more than \$2.00, and shares closed up 5%. By
5 September 3, 2008, a deal had still not been struck between KDB and Lehman, as the two sides
6 continued to negotiate a price, yet the continued possibility of an investment by KDB led to a rise
7 in Lehman shares of 4 cents. On September 9, 2008, shares dropped 44.95% to \$7.79, after reports
8 emerged that KDB had put talks on hold. S&P placed Lehman on CreditWatch, but notably did
9 not downgrade Lehman’s “A” long-term rating.

10 54. On September 10, 2008, one week after Plaintiff purchased nearly \$20 million of
11 Lehman Securities, the Company issued a press release announcing preliminary financial
12 statements for the third quarter ended August 31, 2008. The Company reported a net loss of \$3.9
13 billion and announced “a comprehensive plan of initiatives to reduce dramatically the firm’s
14 commercial real estate and residential mortgage exposure, generate additional capital through the
15 sale of a majority stake of the Investment Management Division and reduce the annual dividend, in
16 order to maximize value for clients, shareholders and employees.” The press release further stated
17 in pertinent part:

18 OVERVIEW OF PRELIMINARY THIRD QUARTER RESULTS

19 Lehman Brothers reported a preliminary net loss of approximately
20 (\$3.9) billion, or (\$5.92) per common share (diluted), for the third
21 quarter ended August 31, 2008, compared to a net loss of (\$2.8)
22 billion, or (\$5.14) per common share (diluted), for the second quarter
23 of fiscal 2008 and net income of \$887 million, or \$1.54 per common
share (diluted), for the third quarter of fiscal 2007. The net loss was
driven primarily by gross mark-to-market adjustments stemming
from writedowns on commercial and residential mortgage and real
estate assets.

24 Net revenues (total revenues less interest expense) for the third
25 quarter of fiscal 2008 are expected to be negative (\$2.9) billion,
26 compared to negative (\$0.7) billion for the second quarter of fiscal
27 2008 and \$4.3 billion for the third quarter of fiscal 2007. Net
revenues for the third quarter of fiscal 2008 reflect negative mark-to-
market adjustments and principal trading losses, net of gains on
certain risk mitigation strategies and certain debt liabilities.

28 During the fiscal third quarter, the Firm is expected to incur negative
gross mark-to-market adjustments on assets of (\$7.8) billion,

1 including gross negative mark-to-market adjustments of (\$5.3)
2 billion on residential mortgage-related positions, (\$1.7) billion on
3 commercial real estate positions, (\$600) million on other asset-
4 backed positions and (\$200) million on acquisition finance positions.
5 These mark-to-market adjustments were offset by \$800 million of
6 hedging gains during the quarter and \$1.4 billion of debt valuation
7 gains. The Firm is also expected to record losses on principal
8 investments of approximately \$760 million.

9 In order to increase operating efficiency, the Firm has eliminated
10 approximately 1,500 positions since the beginning of the third
11 quarter in discretionary corporate areas and businesses that are in
12 secular decline.

13 55. Despite the enormous losses reported in the press release, Lehman continued to
14 downplay the gravity of the Company's financial situation. In a conference call on September 10,
15 2008, the same day the press release was issued, Defendant Fuld stated, "We've been through
16 adversity before, and we always come out a lot stronger." Lehman tried to reassure investors by
17 unveiling a plan to sell part of the Investment Management Division and create a separate unit for
18 its real estate holdings.

19 56. Also on September 10, 2008, S&P announced that Lehman remained on
20 CreditWatch, thus affirming Lehman's underlying ratings, including the A-1 short-term
21 counterparty credit rating. (The second highest rating for commercial paper.) S&P analyst Scott
22 Sprinzen stated that S&P "continue[d] to view Lehman's near-term liquidity as satisfactory...."
23 S&P further stated that it expected to resolve the CreditWatch review within 90 days.

24 57. By Friday, September 12, 2008, Defendant Fuld had approached Bank of America
25 Chairman Kenneth D. Lewis about buying Lehman. A U.S. Treasury official had contacted
26 Barclays of Britain ("Barclays") to suggest it consider a stake in Lehman. Both were apparently
27 viable options for Lehman. Later that day, federal officials announced that there would be no
28 public bailout for Lehman. Mr. Lewis informed Defendant Fuld that Bank of America could not
complete a deal with Lehman without federal help.

58. On Saturday, September 13, 2008, talks with Barclays were still in motion. That
evening, Barclays agreed to buy Lehman, as long as it did not have to take on any bad real estate
assets. Lehman's asset-management division would also have to be spun off. Federal officials
indicated that a group of banks and brokers had agreed to put up enough capital to support a

1 separate company that would hold Lehman's bad real estate assets. In the meantime, Defendant
2 Fuld was still trying to broker a deal with Bank of America.

3 59. The next morning, Sunday, September 14, 2008, the day before Lehman filed for
4 bankruptcy, Defendant Fuld gathered the board of directors at the Company's offices. He expected
5 that the board would approve Lehman's sale to Barclays by midday. The only problem was that
6 Barclays needed a shareholder vote in order for the Lehman deal to go through, and there was no
7 way to have the vote on a Sunday. Barclays needed either the United States or British government
8 to back Lehman's trading balances until the vote could be held. Neither government provided the
9 necessary backing, and the deal fell through. Defendant Fuld postponed the board meeting, and
10 attempted one more call to Mr. Lewis at Bank of America. Later that afternoon, the news broke
11 that Bank of America was in talks with Merrill Lynch. At 8:00 p.m., Lehman's board of directors
12 gathered. SEC chief Christopher Cox informed the board by telephone that it had "a grave matter
13 before it." Defendant Macomber asked whether Cox was directing them to authorize a bankruptcy
14 filing. Cox replied, "You have a grave responsibility and you need to act accordingly."

15 60. On September 15, 2008, approximately four hours after the conclusion of the board
16 meeting, Lehman filed a voluntary petition to reorganize under Chapter 11. This is the largest
17 bankruptcy filing in history. Up until the conclusion of the Lehman board meeting the night
18 before, bankruptcy was inconceivable to the financial community. The market for Lehman
19 Securities became illiquid the morning of September 15, 2008. As a result of Lehman's actions,
20 Plaintiff was forced to mark the value of the Lehman Securities to \$0.

21 61. On September 23, 2008, CNN reported that the Federal Bureau of Investigation
22 ("FBI") is investigating, among other companies, Lehman and their senior executives for potential
23 mortgage fraud. The FBI is reportedly investigating whether anyone at Lehman, including its
24 senior executives, had any responsibility for providing "misinformation." The purpose and intent
25 of Lehman's misleading statements regarding the state of their liquidity and assets was to lull the
26 investing public into a false sense of security, including Plaintiff. Taken in the aggregate, all of
27 these statements show that while some limited negative financial information was being released
28 before the bankruptcy, the picture being painted by Lehman, and supported by the Defendants, was

1 that the situation was under control, the Company would survive, and investments would be safe.
2 Because of the reassurances the Company continued to provide up until the bankruptcy filing,
3 investors such as Plaintiff did not believe they had to take any extraordinary action to protect their
4 investments.

5 **V. PLAINTIFF'S RELATIONSHIP WITH LEHMAN**

6 62. Plaintiff is a municipality organized under the laws of the State of California.
7 Plaintiff's Pool invests public monies received from tax payments, fees, and revenues derived from
8 various departments and commissions such as the harbor, gas department, and water department.
9 Long Beach was the first city managed investment pool to receive a rating for its investment Pool
10 from S&P. In S&P's most recent report, dated September 30, 2008, Plaintiff's Pool received the
11 highest rating possible –AAAf/S1. (Such a rating indicates that the Pool's investments exhibit low
12 volatility and low risk of default.)

13 63. Plaintiff maintained a relationship with Lehman for many years. Not only did
14 Plaintiff purchase Lehman issued commercial paper, but it also used Lehman as an underwriter on
15 its municipal bonds and as a broker dealer in its purchase of other issuers' securities. In its
16 purchase of commercial paper, Plaintiff's investment officers had frequent and direct contact with
17 Lehman employees working for its institutional desk. Moreover, as a purchaser of Lehman
18 commercial paper, including the Lehman Securities purchased on September 3, 2008, Plaintiff's
19 investment officers considered all material public information about Lehman including its SEC
20 filings, financial results, and public statements made by Lehman's officers and directors. In all
21 discussions with Lehman employees at the institutional desk in the weeks and days prior to the
22 purchase of the Lehman Securities on September 3, 2008, Plaintiff's investment officers were not
23 informed of any negative facts nor disclosures about the short-term prospects of Lehman. The
24 Lehman Securities purchased on September 3, 2008 had a short maturity date of September 30,
25 2008, and Plaintiff relied upon the representations about Lehman's prospects in the short-term,
26 including S&P's view that Lehman's near-term liquidity remained satisfactory, as alleged above.
27 Moreover, Plaintiff operated its Pool in a conservative manner, as detailed in the Investment Policy
28 Statement it had adopted and renewed annually with its City Council. At all times, Lehman,

1 through its employees, knew the terms of the Investment Policy Statement, particularly that
2 Plaintiff's Statement set forth requirements for investing that were more conservative than what
3 was required under the California Government Code. Furthermore, Lehman knew that Plaintiff
4 managed its portfolio in a manner that maintained liquidity so that funds were available on dates
5 when Plaintiff knew outflows were necessary. The Securities purchased by Plaintiff were
6 specifically timed to account for the liquidity needed for such an outflow on September 30, 2008,
7 which is the reason for the 27-day term of the Securities. At all times relevant to these claims,
8 Lehman and its employees, officers, and directors were in positions of trust and owed the highest
9 fiduciary duty to Plaintiff.

10 **VI. THE ROLE OF PUBLIC AUDITOR ERNST & YOUNG LLP**

11 64. Defendant Ernst performed an annual audit of Lehman's consolidated financial
12 statements for the fiscal years ended November 30, 2005, 2006, and 2007. In addition, Ernst
13 reviewed the quarterly consolidated financial statements for each of these years, which were in the
14 Company's 10-Q filings. Defendant Ernst issued a "Report of Independent Registered Public
15 Accounting Firm" in the 10-Qs (the same title as used in the audit reports), which was based on
16 Ernst's review of whether material modifications were required to the consolidated financial
17 statements as reviewed by Ernst. This quarterly review work also became part of the annual audit
18 work, and the quarterly review work was relied upon to complete the annual audits.

19 65. By virtue of its longstanding position as Lehman's public auditors and its purported
20 expertise in real estate and complex debt securities markets, Defendant Ernst represented that it
21 was uniquely qualified to act as auditor of Lehman's increasingly complex business operations.
22 Among the critical tasks Ernst had in auditing Lehman's 2005, 2006, and 2007 consolidated
23 financial statements was to ensure that Lehman had properly stated the value of its asset-backed
24 and mortgage-backed securities and its risk of exposure in the real estate and mortgage markets. In
25 particular, Lehman had material exposure to risk in real estate loans it originated on residential and
26 commercial properties, as well as mortgage-backed and asset-backed securities. In certain notes to
27 the audit reports, Lehman touted itself as a "market leader" in both mortgage-backed and asset-
28 backed securitizations and other structured financing arrangements. In essence, Lehman would

1 originate loans and package those loans to sell as securities. In both instances, the quality of the
2 loans themselves, as well as the fair value of those loans, was critical to the financial position of
3 Lehman, and was by virtue of this importance, essential to disclose properly in the consolidated
4 financial statements consistent with financial reporting requirements.

5 66. For each of the fiscal years 2005, 2006, and 2007, Defendant Ernst, by virtue of its
6 unique position as Lehman's auditor, was fully aware that Lehman's very survival depended in
7 large part on the performance of its real estate loan portfolio, mortgage-backed securitizations, and
8 asset-backed securitizations. Defendant Ernst was also uniquely positioned to understand how the
9 real estate market, and the subprime market in particular, could generate huge losses for Lehman.
10 Moreover, at all times Ernst knew that investors, creditors, analysts, and rating agencies, among
11 others, would rely upon the accuracy of Lehman's consolidated financial statements and that
12 Ernst's audit opinion reflected a reasonable and complete examination of those consolidated
13 financial statements by Ernst in accordance with the standards of the Public Company Accounting
14 Oversight Board ("PCAOB"). The SEC has designated the PCAOB as a body with the authority to
15 promulgate auditing and other professional standards relating to audits of public companies in the
16 United States. Public accounting firms who are registered with PCAOB, such as Ernst, must
17 adhere to all PCAOB standards in the audits of issuers such as Lehman.

18 67. Lehman's consolidated financial statements for the fiscal years ended 2005, 2006,
19 and 2007 were materially false and misleading because they, among other things, failed to
20 accurately disclose the true financial condition of Lehman; overstated the fair value of Lehman's
21 real estate assets, including residential and commercial real estate loans originated by Lehman;
22 overstated income; and failed to make necessary disclosures, adjustments, write-downs, or
23 establish adequate reserves related to the value of real estate loans, mortgage-backed securities held
24 by Lehman, and contingencies associated with Lehman's mortgage-backed and asset-backed
25 securitizations. As a result, the Lehman consolidated financial statements were not prepared in
26 accordance with United States Generally Accepted Accounting Principles ("US GAAP"). In
27 performing its audits of Lehman's consolidated financial statements, Ernst failed to perform in
28 accordance with the standards of the PCAOB.

1 68. For each of Lehman's consolidated financial statements for the fiscal years ended
2 2005, 2006, and 2007, Ernst issued an unqualified opinion as to the accuracy of those statements.
3 For example, for fiscal year ended 2007 Ernst stated:

4 **Board of Directors and Stockholders of Lehman Brothers**
5 **Holdings Inc.**

6 We have audited the accompanying consolidated statement of
7 financial condition of Lehman Brothers Holdings Inc. (the
8 "Company") as of November 30, 2007 and 2006, and the related
9 consolidated statements of income, changes in stockholders' equity,
10 and cash flows for each of the three years in the period ended
11 November 30, 2007. Our audits also included the financial statement
12 schedule listed in the Index at Item 15(a). These financial statements
13 and schedule are the responsibility of the Company's management.
14 Our responsibility is to express an opinion on these financial
15 statements based on our audits.

16 We conducted our audits in accordance with the standards of the
17 Public Company Accounting Oversight Board (United States).
18 Those standards require that we plan and perform the audit to obtain
19 reasonable assurance about whether the financial statements are free
20 of material misstatement. An audit includes examining, on a test
21 basis, evidence supporting the amounts and disclosures in the
22 financial statements. An audit also includes assessing the accounting
23 principles used and significant estimates made by management, as
24 well as evaluating the overall financial statement presentation. We
25 believe that our audits provide a reasonable basis for our opinion.

26 In our opinion, the financial statements referred to above present
27 fairly, in all material respects, the consolidated financial position of
28 Lehman Brothers Holdings Inc. at November 30, 2007 and 2006, and
the consolidated results of its operations and its cash flows for each
of the three years in the period ended November 30, 2007, in
conformity with U.S. generally accepted accounting principles.
Also, in our opinion, the related financial statement schedule, when
considered in relation to the basic financial statements taken as a
whole, presents fairly in all material respects the information set
forth therein.

22 We also have audited, in accordance with the standards of the Public
23 Company Accounting Oversight Board (United States), the
24 effectiveness of Lehman Brothers Holdings Inc.'s internal control
25 over financial reporting as of November 30, 2007, based on criteria
26 established in Internal Control-Integrated Framework issued by the
Committee of Sponsoring Organizations of the Treadway
Commission and our report dated January 28, 2008 expressed an
unqualified opinion thereon.

27 69. For the fiscal years ended 2005 and 2006, Defendant Ernst issued similar unqualified
28 opinions. Each of these opinions by Ernst was materially false and misleading at the time it was

1 made. Ernst, as one of the largest public accounting firms in the world, knew that investors,
2 creditors, and others were intended recipients of these audit reports and opinions, and that such
3 users would rely upon the same in deciding to purchase and/or continue to hold Lehman Securities.
4 The continued issuance of clean audit opinions, and the failure to correct existing clean opinions,
5 were critical to Lehman's efforts to maintain a public front of safety and security for investors even
6 while the Company plummeted towards its demise. In providing clean audit opinions, Defendant
7 Ernst gave enormous credibility to Lehman and failed to fulfill its role as a public watchdog, as
8 required by the United States Supreme Court.

9 70. The purpose of Defendant Ernst's audits of Lehman's consolidated financial
10 statements was to reach an opinion as to whether those statements set forth in all material respects
11 Lehman's financial position and results in strict conformity with US GAAP. In planning a
12 complex audit of a company such as Lehman, Ernst had an affirmative duty to both plan and
13 conduct the audits with due professional care so that it could obtain the audit evidence necessary to
14 opine with reasonable assurance that Lehman's consolidated financial statements contained no
15 material misstatements or omissions. *See* AU² §§ 230 and 326. Ernst also had the responsibility to
16 plan and conduct the audits of Lehman so as to detect fraud and the extent to which any such fraud
17 would have a materially adverse effect on the consolidated financial statements. *See* AU § 316.
18 Because of its enormous knowledge of the real estate markets, including the markets for the
19 origination and securitization of subprime loans, Ernst should have been even more cautious than
20 usual in designing audit procedures to detect fraud or negligence that could materially impact
21 Lehman's consolidated financial statements. However, Ernst did not do so.

22 71. A proper audit requires both independence from, and questioning of, consolidated
23 financial statements prepared by Lehman's management. Only with such independence and
24 intellectual detachment from management could Ernst's ultimate opinion regarding Lehman's
25 consolidated financial statements have had a reasonable basis. The audit opinions issued by Ernst
26

27
28 ² "AU" is the codification of auditing standards prepared by the American Institute of Certified
Public Accountants, Inc. as taken from Statements of Auditing Standards ("SAS").

1 for Lehman's 2005, 2006, and 2007 consolidated financial statements gave an unqualified opinion
2 that the statements were prepared in accordance with US GAAP in all material respects.

3 72. In fact, Lehman's consolidated financial statements for 2005, 2006, and 2007
4 violated US GAAP in that the statements materially overstated income and assets for each of those
5 fiscal years. As alleged above, beginning in fiscal year 2005 and continuing through fiscal year
6 2007, Lehman overstated the fair value of its real estate related assets, overstated the income
7 derived from those assets and the securitization of mortgages, failed to establish adequate asset
8 loan loss reserves, or reserves for the contingencies associated with its securitization of mortgages
9 and assets, and overstated the value of such securities that it continued to hold and/or those in
10 which it had a retained interest. As a result, the 2005, 2006, and 2007 consolidated financial
11 statements violated US GAAP, and Ernst's opinions, based upon its audits of those statements,
12 were materially false and misleading.

13 73. As set forth in the Statements of Financial Accounting Concepts ("SFAC"), Concept
14 No. 1, financial statements are audited by independent accountants, such as Ernst, to enhance
15 confidence in the reliability of those statements. Indeed, according to SFAC Concept No. 1,
16 financial reporting should provide information that is useful to investors and creditors, amongst
17 other users of financial statements, and financial statements are recognized to be a basis for making
18 rational decisions as to whether to invest or not. Companies, such as Lehman, and their
19 management are described in SFAC Concept No. 1 as having "stewardship responsibility" to the
20 users of financial statements. The financial information contained therein, and in particular
21 earnings, is commonly the focus for determining whether that stewardship has been properly
22 carried out. Lastly, financial statements need to include explanations and interpretations which
23 help users to understand their contents.

24 74. Under SFAC Concept No. 2, it is a central precept of accounting that financial
25 reporting should be relevant and reliable. "Reliable" means the information should be complete
26 and financial statements should not leave out material facts, especially where such facts are
27 adverse. Management of Lehman, such as the Officer Defendants, knew more about the Company
28 than investors, creditors or other outsiders, and had the responsibility to increase the usefulness of

1 financial reporting by explaining those matters which had a material effect on the financial
2 statements. Defendant Ernst, as Lehman's auditor, was required under PCAOB standards,
3 including AU section 431, to examine the disclosures in the consolidated financial statements and
4 take appropriate action if Lehman management omitted material information required by US
5 GAAP.

6 75. Instead of adhering to these well established concepts, Lehman prepared and issued
7 its note disclosures in a way that disaggregated the facts, and made it difficult to determine its true
8 exposure to the downturn in the real estate market. The note disclosures, and in particular the notes
9 related to securitizations and other off-balance sheet arrangements, were incomplete and failed to
10 disclose relevant facts in a manner that allowed the user of the consolidated financial statements to
11 determine just how exposed Lehman was to such a downturn and the risks inherent in such an
12 event. The notes provided certain factual information, but did not put it in an appropriate context.
13 For example, in the consolidated financial statements for the fiscal year ended 2006 and issued on
14 February 13, 2007, Lehman disclosed that it securitized approximately \$146 billion of residential
15 mortgages in 2006 and \$133 billion in 2005. However, the footnotes fail to adequately disclose
16 how much of those securitizations were in subprime loans, the quality of the creditworthiness or
17 collateral for these securities, or the contingent risk related to subprime securitizations wherein
18 Lehman had retained an interest.

19 76. These failures to adequately disclose, and to obfuscate by disaggregating material
20 information are significant. For example, the reported income before taxes for Lehman for 2005
21 was \$4.829 billion and \$5.905 billion in 2006. In comparison, Lehman's interests in securitizations
22 for residential mortgages was \$7.4 billion for 2005 and \$7.9 billion in 2006. Write-downs, write-
23 offs, or reserves for low quality loans and retained interests in securitizations, including those for
24 subprime loans, would have a materially adverse impact on income as well as cash flow.

25 77. In Note 11 to the 2006 audited financial statements, Lehman supposedly discloses
26 "Commitments, Contingencies and Guarantees." With respect to loan originations, the note
27 discloses that at the end of fiscal year 2005, Lehman had \$7.7 billion in residential mortgages, and
28 \$7.0 billion in 2006. Note 11 refers back to Note 3 for further information about Lehman's

1 securitization activities. However, neither footnote makes any disclosure about reserves for bad
2 real estate loans, potential write-downs, or write-offs.

3 78. In the consolidated financial statements for the end of fiscal year 2007, Lehman
4 disclosed its subprime residential loan portfolio for the first time. The title of Note 3 for 2007 was
5 changed from "Securitizations and Other Off-Balance Sheet Arrangements" to "Financial
6 Instruments and Other Inventory Positions," a particularly obscure title given the financial
7 problems that Lehman was already experiencing in its residential mortgage portfolio. That note
8 also flatly states: "We do not consider ourselves to have economic exposure to the underlying
9 assets in those securitization vehicles." This refers to balances in mortgage-backed and asset-
10 backed securities, which were purportedly transferred, of approximately \$12.8 billion in 2007 and
11 \$5.5 billion in 2006. The disclosures about non-investment grade retained interests in
12 securitizations is relegated to a footnote, and the format for disclosing mortgage-backed and asset-
13 backed securities is changed so as to make it harder to compare the same note in 2006 to the one in
14 2007. Lastly, the note discloses that Lehman's total portfolio of U.S. residential subprime
15 mortgages was \$5.276 billion in 2007 and \$6.849 billion in 2006. There are no disclosures about
16 the risks associated with this portfolio, including, but not limited to, foreclosures, write-offs, write-
17 downs, and the necessity of reserves. Despite the fact that net income before taxes, as set forth in
18 the 2007 income statement, was \$6.013 billion for 2007 and \$5.905 billion for 2006 (meaning that
19 the total exposure to the subprime portfolio was greater than pre-tax income in 2006 and accounted
20 for most of the Company's income in 2007), Lehman fails to adequately disclose critical facts
21 about the impact of its subprime portfolio on its financial condition. Given the dire circumstances
22 known to the Individual Defendants, and Defendant Ernst, as of the end of fiscal year 2007, the
23 mere disclosure of the amount of the subprime portfolio, without disclosure of the risks associated
24 therewith, is materially misleading.

25 79. In addition, for an investor to determine the true facts about Lehman's exposure to
26 the subprime market, that investor would not only have to aggregate the information found in
27 separate places in the consolidated financial statements, but it would also have to figure out the
28 relationship between the loans originated by Lehman and the securitizations related thereto. Once

1 real estate loans are originated by Lehman, they are then packaged as securities (*i.e.*,
2 securitization), and sold to investors. Lehman “derecognizes” the financial assets transferred as
3 securitizations once Lehman relinquishes control. This has the effect of taking them off Lehman’s
4 balance sheet.

5 80. By failing to adhere to basic concepts of financial reporting and auditing, the
6 Individual Defendants and Defendant Ernst deprived investors, such as Plaintiff, of the information
7 necessary to make an informed decision about their investments.

8 **VII. FIRST CAUSE OF ACTION**

9 **Violation of California Corporation Code § 25400, *et seq.***

10 **(Against All Defendants)**

11 81. Plaintiff incorporates by reference all the above allegations as though fully set forth
12 herein.

13 82. This claim is made against all Defendants.

14 83. Defendants disseminated within California false and misleading documents and
15 information concerning Lehman’s financial condition, as hereinabove alleged, for the purpose of
16 inducing Plaintiff to purchase and hold the Lehman Securities. Defendants acted both individually
17 and as part of a conspiracy in performing such acts. At all times, Defendants knew or should have
18 known that the documents and information they disseminated, or assisted in disseminating, were
19 false and misleading and/or failed to reveal material facts necessary to make the statements not
20 misleading. As a direct result of such dissemination of false and misleading documents and
21 information, Defendants knew that persons purchasing and holding the Lehman Securities,
22 including Plaintiff, would rely on such false statements in purchasing and holding the Lehman
23 Securities. Defendants made such false and misleading statements for the purpose of inducing
24 Plaintiff to purchase and retain the Lehman Securities.

25 84. In violation of California Corporations Code section 25403, each of the Defendants
26 provided substantial assistance to each of the other Defendants in the dissemination of the false and
27 misleading statements.

1 85. Each of the Defendants willfully participated in the wrongful acts alleged above. As
2 a direct and proximate result of the wrongful acts and conduct of Defendants as alleged above,
3 Plaintiff has suffered financial harm and other general and special damages including damages
4 recoverable under California Corporations Code section 25500 and/or section 25501, in an amount
5 to be determined. Plaintiff also seeks an award of prejudgment interest as provided by California
6 Corporations Code section 25500 and/or section 25501.

7 **VIII. SECOND CAUSE OF ACTION**

8 **Fraud and Deceit**

9 **(Against All Defendants)**

10 86. Plaintiff incorporates by reference all the above allegations as though fully set forth
11 herein.

12 87. This claim is made against all Defendants.

13 88. The conduct of Defendants as alleged herein constituted a fraud against Plaintiff.
14 Defendants made false representations, concealments, and omissions of material facts to Plaintiff,
15 knew and/or were reckless in not knowing that the same were false, and in so doing intended to
16 defraud Plaintiff. Plaintiff did in fact innocently rely upon those false representations,
17 concealments, and nondisclosures by Defendants. In relying on the false and misleading
18 statements of Defendants, Plaintiff was induced to purchase and retain the Lehman Securities, and
19 such reliance was justifiable in light of the circumstances.

20 89. The conduct of Defendants, as alleged herein, violated sections 1709 and 1710 of the
21 California Civil Code, and renders Defendants liable to Plaintiff for fraud and deceit. Defendants
22 violated those provisions in the following manner: (i) making representations of fact that were not
23 true and which Defendants did not believe to be true (Cal. Civ. Code § 1710(1)); (ii) suppressing
24 and/or failing to disclose facts that Defendants were bound to disclose, or giving information or
25 other facts that were likely to mislead for failing to communicate the facts suppressed or
26 undisclosed (Cal. Civ. Code § 1710(3)); and (iii) making promises without any intent of
27 performing them (Cal. Civ. Code § 1710(4)).
28

1 90. Defendants aided and abetted, encouraged, and rendered substantial assistance in
2 accomplishing the wrongful conduct, their wrongful goals, and other wrongdoing complained of
3 herein. In taking such actions, each Defendant acted with an awareness of his, her, or its primary
4 wrongdoing and realized that his, her, or its conduct would substantially assist the accomplishment
5 of the wrongful conduct, wrongful goals, and other wrongdoing complained of herein.

6 91. Defendants pursued a conspiracy, common enterprise, and common course of
7 conduct to accomplish the wrongs complained of herein. The purpose and effect of the conspiracy,
8 common enterprise, and common course of conduct complained of herein was, among other things,
9 performed for the financial benefit of Defendants at Plaintiff's expense by illegal, fraudulent, and
10 wrongful activities. Each Defendant was a direct, necessary, and substantial participant in the
11 conspiracy, common enterprise, and common course of conduct complained of herein, and was
12 aware of his, her, or its overall contribution to, and furtherance of, the conspiracy, common
13 enterprise, and common course of conduct. Defendants' acts of conspiracy include, among other
14 things, all of the acts that each are alleged to have committed in furtherance of the wrongful
15 conduct complained of herein.

16 92. As a direct and proximate result of the wrongful and fraudulent conduct of
17 Defendants, Plaintiff has suffered and continues to suffer substantial economic losses and other
18 general and specific damages, including, but not limited to, out-of-pocket losses, payment of
19 commissions and fees to Defendants, and lost interest, all in an amount to be determined according
20 to proof at the time of trial.

21 93. The wrongful acts of Defendants as complained of herein were done with malice,
22 oppression, and intent to defraud, and with conscious disregard for the rights of Plaintiff, and the
23 wrongful acts of Defendants were committed at the behest and in furtherance of the business of
24 each other Defendant and/or were authorized and/or ratified by each Defendant. Plaintiff is entitled
25 under California Civil Code section 3294 to recover punitive damages from Defendants in an
26 amount to be determined according to proof at the time of trial and which is appropriate to punish
27 Defendants and make an example of Defendants in order to deter others from similar conduct.
28

1 IX. **THIRD CAUSE OF ACTION**

2 **Negligent Misrepresentation**

3 **(Against All Defendants)**

4 94. Plaintiff incorporates by reference all the above allegations as though fully set forth
5 herein.

6 95. This claim is made against all Defendants.

7 96. Defendants made false representations, concealments, and nondisclosures to Plaintiff.
8 In making said false representations, concealments, and nondisclosures to Plaintiff, and in doing
9 the things alleged above, Defendants, and each of them, acted without any reasonable grounds for
10 believing said false representations, concealments, and nondisclosures were in fact true, and
11 intended thereby to induce the reliance of Plaintiff thereon. Plaintiff did in fact innocently rely
12 upon said false representations, concealments, and nondisclosures in purchasing the Lehman
13 Securities and continuing to hold the Securities. Such reliance was justifiable in light of the
14 circumstances.

15 97. Defendants, and each of them, aided and abetted, encouraged, and rendered
16 substantial assistance to each other in accomplishing the wrongful conduct, their wrongful goals,
17 and other wrongdoing complained of herein. In taking such actions, each Defendant acted with an
18 awareness of his, her, or its primary wrongdoing and realized that his, her, or its conduct would
19 substantially assist the accomplishment of the wrongful conduct, wrongful goals, and other
20 wrongdoing complained of herein.

21 98. As a direct and proximate result of Defendants' representations, concealments, and
22 nondisclosures to Plaintiff and Plaintiff's justifiable reliance thereupon, Plaintiff has suffered and
23 continues to suffer substantial economic losses and other general and specific damages, including,
24 but not limited to, out-of-pocket losses, fees to Defendants, and lost interest, all in an amount to be
25 determined according to proof at the time of trial.

26 X. **PRAYER FOR RELIEF**

27 WHEREFORE, Plaintiff demands that judgment be rendered in favor of Plaintiff against
28 Defendants as follows:

1. For compensatory and general damages according to proof;
2. For special damages according to proof;
3. For prejudgment interest at the maximum legal rate;
4. For punitive and exemplary damages according to proof;
5. For the costs of the proceedings herein;
6. For Plaintiff's reasonable attorneys' fees; and
7. For all such other and further relief as the Court deems just and proper.

XI. DEMAND FOR JURY TRIAL

Plaintiff hereby demands a trial by jury in this action.

Dated: February 5, 2009

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